Responsibilities of Regulatory Agencies

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In for-profit conversions of nonprofit organizations, the Attorney General's office has an important job to protect the charitable assets. That is defined as the fair market value of the company or the business at the time a conversion agreement is reached. It has nothing to do with tax breaks. Calculating the value of past tax breaks might be appropriate to an analysis from a policy point of view, but the law is quite clear in New York. Empire must leave behind an equivalent value in the nonprofit sector if the conversion is to be approved. The Attorney General must ensure that such a result occurs. The Attorney General's office also plays a second role: to ensure that those assets, when left behind, are deployed for an appropriate charitable purpose under the applicable legal doctrines in New York.

It is not an appropriate role of the Attorney General, or the government, to decide whether there should be a conversion. That responsibility falls on the fiduciaries, Empire's board of directors. But it is our job to review on what terms such a conversion might take place and at what time.

That is not to say the Attorney General will not oppose certain conversions, but the law leaves the initial choice to the directors. With that power comes some responsibility.

Applicable Law

Let us begin with the basics of the law. Sections 510 and 511 of the Not-For-Profit Corporation Law control sales of "all or sub-

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stantially all" the assets of any nonprofit corporation in the State of New York. Because this is a transfer of all or substantially all of Empire's assets, the requirements of that statute must be met.

The first requirement of the statute is that Empire should receive consideration in the conversion that is fair and reasonable to the corporation. That is not to say the highest price, but a fair one. Inevitably, that is a question of comparability, so the Attorney General starts with the issue of alternatives. The first line of inquiry for the Attorney General is whether a conversion or some other kind of transaction is appropriate. We anticipate a detailed discussion as to whether Empire explored other avenues before going public with this proposal.

Second, the statute requires that the transaction serve "the interests of the corporation." We understand this phrase to mean that considerations other than price can be taken into account in the courts' and our reviews. So, we would oppose that conversion if it has features other than the straight consideration that, for example, puts the assets at risk in a way that we find unwarranted.

The question is, can the mission of the newly created charitable entity or any existing charitable entity that might receive these funds realistically be achieved pursuant to the terms that are being proposed here?

Another topic that is not yet settled concerns the disposition of the charitable proceeds. This will have to be proposed and reviewed, and public input will have to be obtained, but the law is clear.

The doctrine that will apply in New York is not that of *cy pres* or approximation, but rather it is something that we call "*quasi cy pres*." Although in other circumstances, I might be at a loss to explain the difference between the two, I think in this case I can point to factors that probably will accord more flexibility to Empire because it is *quasi cy pres* rather than *cy pres*.

Cy pres would require the corporation to transfer these funds, assuming that a conversion were otherwise approved, to an entity whose purposes are the closest approximation to those set forth in Empire's existing certificate of incorporation.

I would observe without judgment that this probably would be another nonprofit HMO in the State of New York. That is not what is proposed here and is not what must happen.

I think that the doctrine of *quasi cy pres*, at least as set forth in the appellate precedents that seem to be most applicable—*Alco Gravure v. Knapp* in the amendment of purposes context and the *Multiple Sclerosis Service Organization* case in the context of dissolution—require only that the purposes to which the assets will be put thereafter be close to or within the ambit, if you will, of the purposes and the programs of the organization that is converting or transferring its assets. This doctrine will accord Empire the flexibility to offer not only its governing instruments, but also its long history, in an attempt to argue for its proposal to create a new charitable foundation.

That history is long and varied: 65 years of history lead to this proposal. That history includes alliances with many organizations, public and private, and I believe that it will be a complicated task in sorting out the meaning of Empire's "purpose" in trying to apply the legal doctrine.

Issues to be Addressed by the Attorney General's Office

None of Empire's directors, officers, or managers may benefit solely as a result of this transaction. There will be disclosure of all of the relevant documents on that issue as well as every other issue, and Empire's officials will have to commit to that position under oath in their supporting papers.

Mr. Mancino has spoken before on this issue and has observed that the days of the self-dealing conversion are probably ending, if not over, and that what we are seeing today are capital-driven conversion proposals. I think that this is generally true, and it is certainly a capital-driven proposal in Empire's case.

Empire is proposing what has been called a "drop down" conversion, in which a nonprofit's assets are moved into a subsidizing organization. Such conversions raise issues that we will review and

analyze in this case. One is the risk to the charitable asset. This is a primary concern in any proposal in which the stock of the new for-profit company is held by the nonprofit foundation, in whatever structure or variation it might finally be created.

Concentration is among the risk issues that have to be addressed here, as has been noted. How long must this stock be retained? Or, how long ought the stock be retained by the charitable foundation? How much stock ought to be sold in an initial public offering or soon thereafter?

In addressing the initial public offering issue, I am concerned, subject to the opinions of the investment bankers, that Empire's current proposal would put 100% of the proceeds from the initial public offering directly into the charitable foundation. This may seem counter-intuitive, coming from someone whose job it is to protect the charitable asset, but that outcome may not be desirable if there is a significant depressing effect on the market price of that stock at that time.

On the other hand, if 100% of the initial public offering were to go into the company, it would leave the foundation without liquidity, unable to begin its charitable mission. A compromise may have to be struck, along with issues of timing. I think that there is probably no simple answer, only the most profitable answer.

Other artificial depressors of market value have been mentioned in earlier presentations. These are very vexing problems, and there may not be any easy answers to them. Among them are the excess business holdings rules in the Internal Revenue Code that Mr. Mancino cited. While extensions of time are available from IRS on the 5-year deadline for divesting excess holdings in a particular business, it is far from clear whether such an extension would be available under these circumstances. That is a problem that will need to be addressed.

The Blue Cross Blue Shield Association rules unfortunately may serve to depress significantly the value of the stock, as Mr. Mancino also noted. Although I understand that they have their purposes, to the extent that those rules can be stretched and

extended, I think it would be all to the benefit of Blue Cross and Blue Shield.

With regard to the creation of the new charitable entity, the legal nature of the entity is really a tax law question—whether there be one foundation or two, a 501(c)(3) or a 501(c)(4)—that I think is still very much under discussion. Most probably, it is not an adversarial issue, rather one that simply needs the correct or best answer.

With regard to identifying the mission: if a new charitable foundation is, indeed, to be the recipient of these funds, there is an inherent tension between specificity needed to assure that we adhere to the legal doctrines and flexibility needed by the foundation's board to decide the most efficient deployment of this asset. The scale probably tips toward the latter. It remains to be seen whether the sort of general proposal that Empire so far has advanced on this score is one that will survive the crucible of public input.

With regard to the selection of the board and the role of Empire's existing board in that process, I raise the question of whether any representation on the new board of the charitable foundation is appropriate. Clearly, control is not appropriate and I do not think that has ever been under discussion. But one of the issues that will have to be addressed is whether some sort of minority or extreme minority representation on that board bears any problems. There are the Blue Cross/Blue Shield Association rules with regard to whom, at least nominally, makes the selection. It seems as if an appropriate mechanism has been designed at least to satisfy the letter of those rules.

There is also the question: Who decides who picks board members for the foundation? Government is uniquely unqualified to do so. It is a role I think the Empire board, in the first instance, will have to play. Ultimately, the courts will have to review at least a process, if not the identification of the individual board members. One subject under discussion is whether that ought to take place before a court application, so that all of those new board members have been selected, or whether it can wait until some period

afterwards, pursuant to a process that has been approved by the courts.

Lastly, this conversion must be approved by a Justice of the Supreme Court in the county in which Empire's principal place of business is located, New York County. No participants in this conference will make that decision. If Empire is able to pass through all of the obstacles and hurdles that may be placed before it by various regulatory agencies, then, ultimately, a judge will decide. Those who will appear in those proceedings are, by statute, Empire and the Attorney General. We will act in aid of the courts in those proceedings. We have designed, I think, a process that will allow for maximum public input before that time.

Procedures Followed Pursuant to Fulfilling the Attorney General's Role

Whereas the Attorney General has the legal standing in this case, we represent the ultimate charitable beneficiaries of Empire's assets, which is to say those who currently benefit from Empire's assets and those who might benefit from those assets. That is everyone, essentially.

There will be five public information sessions at various locations in Empire's service area. We hope that all of those who have an interest in this will be able to participate in that process.

All of the documents on which the Attorney General might or might not rely, save those that are trade secrets that would damage the charitable interest were they to be released to the public, will be disclosed in advance of those public information sessions so that they are meaningful.

Where do we stand today? We are selecting an investment banker who will serve as our advisor. We have already hired a foundation expert who will advise us on the structure of the new foundation, should that be the solution that is ultimately adopted. Both of those advisors are being retained at Empire's expense, but not subject to Empire's control.

After the public information sessions, there will be an opportu-

nity to reflect on any ideas that have been presented in those sessions. Hopefully, the conversion will then be finalized and presented to the court. At some point thereafter, if an actual public offering is the ultimate version that is approved, there will be a mutual public offering of stock (IPO) in Empire at a time to be determined by market conditions. The IPO will be subject to the legal obligations in the Securities Law and whatever terms in the agreement we work out with Empire.

I conclude with an observation about other states. In New York, we are in the early stages of this process. I have had occasion to look around the country in my role as the President of the National Association of State Charities Officials, and I must say that we are off to a fairly clean and good start. When I look at the litigation that has gone on in other states and how those problems began, they seem like they began on some other planet than Earth. We will proceed with our fingers crossed.